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ZURICH®

The outlook for Eurozone earnings

Above trend growth will support profits despite the stronger euro

In 2018, growth in the Eurozone is likely to be the fastest it has been in ten years. This will boost corporate earnings, particularly as there are also increasing signs that firms are regaining pricing power. Indeed, despite the stronger euro, we expect earnings growth in the mid-teens in 2018. This is above consensus and should support Eurozone equity markets this year, especially relative to fixed income markets.

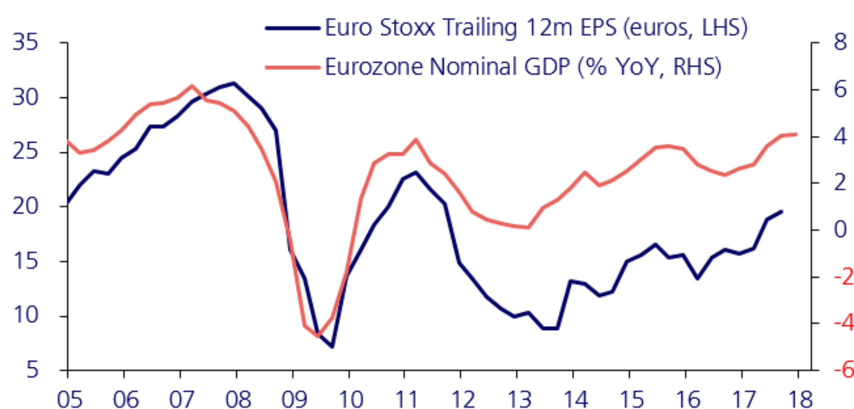
Source: iStock by Getty Images

We think that robust economic growth and business activity in the Eurozone in 2018 will likely lead to corporate earnings growth in the mid-teens, despite the recent strength of the euro.

This is above consensus expectations. Top down analysts are forecasting earnings growth of only around 9% YoY in 2018. However, we think these analysts are overestimating the negative impact that the recent strength of the euro will have on Eurozone company earnings and underestimating the positive impact from robust growth and stronger pricing power that Eurozone companies are currently experiencing.

Admittedly, part of the difficulty in understanding the earnings outlook for the Eurozone is that there are many sectors, such as exporters, energy and commodity producers, and financials, where profitability can be driven by highly idiosyncratic factors.

Mind the gap, earnings and GDP growth diverged from 2011



Source: Bloomberg

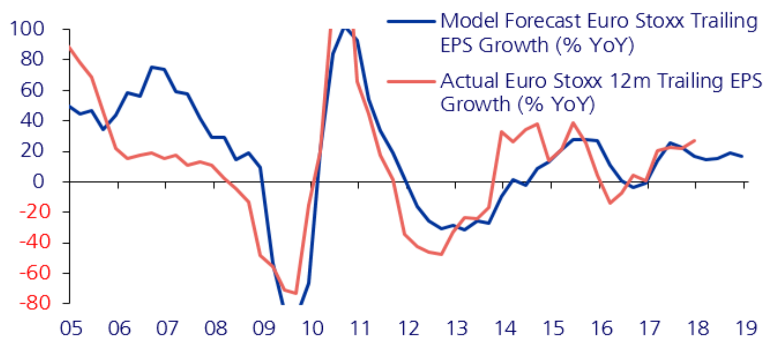
Indeed, from 2011 a gap opened up between earnings and the economy due to structural problems in the financial sector and later the collapse in commodity prices in 2015 and 2016 (see chart). We therefore cross-check our aggregate/macro analysis of earnings trends with an examination of the earnings outlook at a disaggregated sector level, given the many moving parts that can affect overall Eurozone earnings growth.

The economy and earnings

There is normally a close relationship between the business cycle and earnings growth. Strong economic growth allows companies to increase profits through higher revenues and wider margins because of improved pricing power. While wages should also move higher when the economy is growing, which could compress margins, this effect tends to be outweighed by companies' improved pricing power and rising demand for their products, especially in the early and middle part of the economic cycle.

Eurozone company profits tend to be particularly sensitive to the economic cycle because firms have limited room to cut costs in the bad times, and are highly operationally geared as a result. Wages and employment levels are generally less flexible in the Eurozone than in other parts of the world such as the US and Asia.

Model points to earnings growth in mid-teens in 2018



Source: Bloomberg, Zurich IM MSME

Note: Based on regression of 12m trailing Euro Stoxx earnings growth against the YoY change in the trade-weighted euro, Eurozone GDP growth and the annual change in the composite PMI output prices component. Adjusted R-Squared 0.80, all variables statistically significant. Dummy variable from 2011 included to account for structural shift in profitability.

The Eurozone economy is booming

Fortunately, the Eurozone is currently experiencing a growth boom. In Q4 2017, the Eurozone grew 2.7% YoY, close to its fastest pace since Q1 2011. What's more, business confidence, as measured by the Eurozone composite PMI survey, was at its highest levels since 2006 in January. A mix of favourable factors has generated strong growth. Easy financing conditions, less political uncertainty, still loose monetary policy and an absence of fiscal headwinds are all helping. Strong global growth, especially in emerging markets, is also a tailwind.

The increasingly synchronised recovery within the Eurozone, with more and more countries participating, is also helping. Earlier in the recovery the pickup in growth was led by Germany and smaller periphery economies such as Ireland and Spain. However, in recent quarters Italy and France have also started to participate. Falls in unemployment levels in France and Spain have accelerated recently, and business confidence has picked up sharply. This is important to the region at large given the size of their economies.

Overall, we expect Eurozone growth of around 2.8% YoY in 2018, which would be the strongest pace since 2007. What's more, there are upside risks to this forecast, and growth in the Eurozone could even be above 3% this year.

A model of earnings growth

A regression of Eurozone earnings growth against various economic indicators, such as the 12-month change in the trade-weighted euro, GDP growth and the change in the PMI output prices index has a good statistical fit. Given our view that Eurozone growth will be around 2.8% YoY, the model points to earnings growth in the mid-teens in 2018, even after taking into account the stronger euro.

Indeed, there are increasing signs of companies regaining pricing power, which will be a positive tailwind for earnings growth over the next few quarters. For example, the monthly services PMI prices charged index, which measures the level of prices that are charged by Eurozone service sector companies, is close to its highest level since 2008. Earnings growth in the mid-teens would be a supportive environment for Eurozone equities, especially as analysts are not yet expecting such a pace of growth.

Could a stronger euro be a headwind to earnings?

Rather, top down analysts seem to be too focused on the strength of the euro as a headwind to Eurozone company earnings. Admittedly, since mid-April 2017, the euro has appreciated by around 7% on a trade-weighted basis. Eurozone companies generate, on average, only about 56% of their revenue from within the Eurozone, with the rest coming from overseas. Therefore, the level of the exchange rate can have a significant impact on exporter and overall Euro Stoxx earnings.

However, we find that by far the biggest determinant of earnings growth historically has been business activity. What's more, our estimate of earnings growth in the mid-teens in the Eurozone this year already takes into account the appreciation in the euro that we have seen in the past year and its impact on earnings, and also assumes a further 5% appreciation in the euro through the course of 2018 on a trade-weighted basis.

In addition, the strength of the euro should be less of an issue for Eurozone company earnings when domestic growth is strong, as it is now. With the Eurozone recovery increasingly domestically driven and unemployment continuing to fall, this should support domestically focused company earnings. Consumer plans to purchase big ticket items are increasing sharply as unemployment falls.

The exchange rate is a key determinant of relative sector performance

The exchange rate is more likely to be a key determinant of relative sector performance and earnings growth rather than absolute or overall Eurozone company earnings growth, in our view. In particular, the level of the euro is an important driver of relative sector price performance when comparing sectors with large and small international exposures.

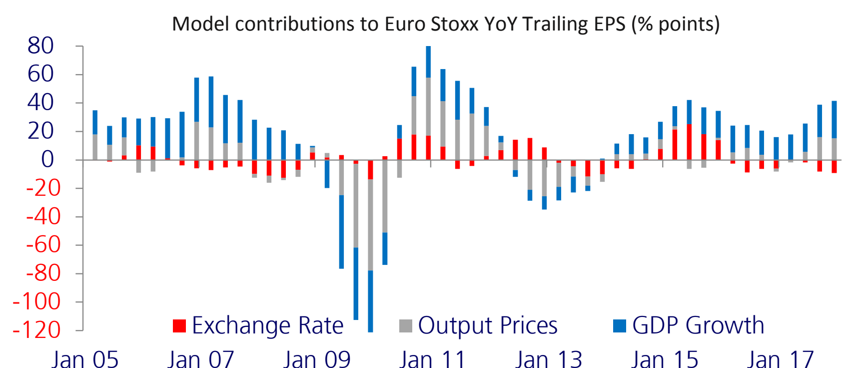
For example, utilities derive only around 30% of their revenues from outside the Eurozone, whereas the healthcare sector generates more than 70% of its revenues from outside the Eurozone. The relative price performance of the Euro Stoxx utilities sub-index compared to the healthcare sub-index does correlate closely with the level of the euro and a similar relationship to the currency is found when looking at underlying earnings of the two sectors as well. However, at an aggregate level for Eurozone companies overall, the level of the exchange rate becomes less important.

The devil is in the detail

Finally, it is important to crosscheck the conclusions from our aggregate/macro analysis by an examination of any special factors at a sector level to see if they could be an extra drag or boost to earnings and to what extent.

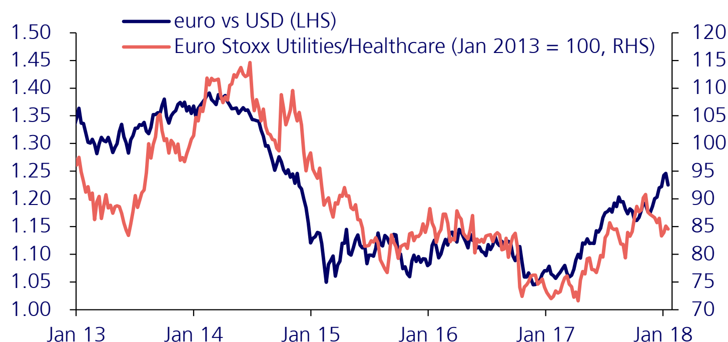
For example, in 2015 and early 2016, even as economic growth accelerated with the region finally emerging from the Eurozone debt crisis and recession, earnings growth remained very weak. This was because of a combination of special factors relating to the commodities and energy sectors and ongoing issues in the banking sector.

Business activity & pricing power key for earnings, not just the euro



Source: Bloomberg, Zurich IM MSME, based on regression model presented in chart above.

The euro is a key determinant of relative sector performance



Source: Bloomberg

Oil prices can have a significant impact on overall earnings

While energy companies represent only around 5% of total Eurozone equity market capitalisation, the high volatility of energy prices and therefore of energy company earnings, means the energy sector can have a significant impact on overall earnings growth when there are large moves in oil prices.

What's more, the inherent volatility of oil prices has been exacerbated recently by the development of new technologies such as fracking and shale oil. From mid-2014 to early 2016, Brent crude prices fell by 75% from around $110 per barrel to just under $30 per barrel at their low point in early 2016.

Low oil prices were a significant drag on energy and overall Eurozone company earnings. However, oil prices have since recovered with Brent trading currently around $65 per barrel. The result is that oil prices have stopped being a headwind to earnings and instead have become a tailwind.

Indeed, oil prices were a boost to YoY earnings growth in 2017. Even if oil prices simply stay around current levels over the next few quarters, favourable base effects mean they should continue to have a positive impact on energy earnings growth through most of 2018.

Banks have also weighed on earnings

Another special factor that has driven a wedge between economic growth and earnings growth relates to the problems of Eurozone banks. Financials represent around 22% of the MSCI Euro index so the outlook for bank profitability, as well as other financials, can have a substantial impact on overall corporate earnings.

Eurozone banks in particular have been affected in recent years by high levels of NPLs, substantial regulatory fines and overcapacity in the sector affecting profitability. However, looking forward, while many banks continue to have severe legacy issues due to high levels of NPLs, which will likely still weigh on profitability, the amount of fines and level of restructuring costs appears to be diminishing at least.

In summary, many of the special factors that caused the negative divergence between earnings growth and economic growth in 2015 and 2016 and earlier have diminished, though they have not been eliminated.

Investment implications & conclusions

The combination of strong economic growth, diminishing headwinds from special factors, firms regaining pricing power and strong domestic demand suggests Eurozone earnings growth could be in the mid-teens this year in our view.

Despite the recent volatility in equity markets, this should be enough to generate positive performance from regional equity markets, especially relative to fixed income assets. Indeed, even without any multiple expansion, earnings plus dividend growth would imply double-digit returns from local equity markets.

One concern that could be raised is that investors already expect such a positive earnings outcome. However, top down analysts' earnings expectations are currently for growth of only 9%, so relative to this, mid-teens earnings growth would be a positive surprise.

Furthermore, top-down analysts tend to revise down rather than up, their earnings expectations through the course of the year and equity markets often still show positive performance. So if analysts' earnings expectations are revised up instead this should be even more of a positive signal for investors.

Domestic demand rebounds; plans for big-ticket purchases increase

Source: Bloomberg

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